

	US	UK
Wheat (Bushels/hr)	6	1
Cloth (Yards/hr)	4	5

In 1 hour, US is ~~producing~~ producing 6 bushels of wheat while UK produces 1 bushel.

\therefore US has absolute advantage for wheat.

In 1 hour, UK produces 4 yards of cloth while US produces 5 yards of cloth.

\therefore UK has absolute advantage for cloth.

\rightarrow US will not trade for cloth from UK if it is not getting more than 4 yards.

\rightarrow Similarly UK will not trade for wheat from US if it is not getting more than 1 bushel.

Let us assume $6 \text{ bushels of wheat} = 6 \text{ yards of cloth}$ or the

exchange rate.

Taking the case of US which needs cloth from UK.

Suppose it ~~takes~~ needs 6 yards of cloth (as per the exchange rate)

~~it also~~

But it already can produce 4 yards of cloth by itself.

So for the additional 2 yards of cloth, it would normally take $\frac{1}{2}$ hours. (since US takes ~~1 hr~~ 1 hr for producing 4 yards)

Therefore, by importing cloth, US saves $\frac{1}{2}$ hour.

Taking care of UK, UK needs wheat from US.

As per exchange rate, UK ~~needs~~ ^{needs} 6 bushels of wheat from US.

UK can already produce 1 bushel per hour by itself.

If it ~~had~~ had to make 5 more bushels by itself, it would take 5 hours.

So UK saves 5 hours by importing.

Theory of Comparative Advantage (David Ricardo)

According to law of Comparative Advantage, even if a nation

is less efficient than the other nation in production of

both commodities, there is still a basis for mutually

beneficial trade.

The first nation should specialise in the production and

export of the commodity in which its absolute disadvantage

is smaller and import the commodity in which its

absolute disadvantage is greater.

	US	UK
Wheat	6	1
Cloth	4	2

In this case UK is a ~~greater~~ disadvantage in both commodities.
 However, it has a lesser disadvantage in case of cloth.

In such a case, we need to find the Trade Possibilities.

UK needs ~~to~~ wheat and will export cloth to US.

① US will need more than 4 units of cloth since it can already produce that by itself.

② Similarly UK will need more than 1 unit of ~~wheat~~ since it can already produce that by itself.

Suppose exchange rate $6W = 6C$

So US gains 2 ~~units of cloth~~ and saves $\frac{1}{2}$ hour
 and UK diverts all resources to cloth.

$$\text{In 1 hr} = 2C$$

$$\text{In 6 hr} = 12C$$

6C
to US

6C
to domestic.

$$\text{For } 6W = 6C$$

US gains 4 units of

cloth and

saves 1 hour

~~UK diverts~~

$$\text{In 1 hr} = 2C$$

$$6 \text{ hr} = 12C$$

6C to
~~to US~~
US

4C to
domestic

According to Law of Comparative advantage, even if one nation has an absolute disadvantage compared to other nation in both commodities, there is still a basis for mutually beneficial trade.

Here, UK cannot export anything to US if it is less efficient than the US in prodⁿ of both commodities.

Trade will take place if the wages in the UK will be sufficiently lower than wages in the US so as to make

the price of cloth lower in UK and the price of wheat lower in US. where more commodities are exported in

terms of the currency of either nation.

Advantage in relation to Wage Rate

US

UK

US pays \$6 for 1 hour

UK pays £1 for 1 hour.

Price of wheat $P_w = \$1$

$P_w = £1$

Since 6W in 1 hour

$P_c = £0.5$

for US

Price of cloth $P_c = \$1.5$

since 2C = £1 in 1 hr

since 4C in 1 hour

$1C = \frac{1}{2} = £0.5$

4C = \$6

1C = $\frac{6}{4} = 1.5$

	US	UK
P_w	\$1	£1
P_c	\$1.5	£0.5

Exchange Rate

$$£1 = \$1$$

$P_w = \\$1$		US	UK	
P_w		\$1	\$1	(Trade Unbalanced)
P_c		\$1.5	\$0.5	

so cloth production is cheaper in UK

16 ~~£1 = £2~~ $£1 = \$2$

(Trade Balanced)		US	UK		
	P_w	£0.5	£1	P_w	\$1 \$2
	P_c	£0.75	£0.5	P_c	\$1.5 \$1 ✓

∴ Then cloth production cheaper in UK but wheat prodⁿ cheaper in US.

16 $\$3 = £1$

	US	UK	
P_w	\$1	\$2	(Trade Unbalanced)
P_c	\$1.5	\$1.5	

∴ Then wheat prodⁿ cheaper in US, but cloth prodⁿ is